Playing Emerging Markets

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Dear Clients and Prospective Clients:

There are very good reasons to avoid investing in emerging markets. Below is a list of some of those reasons:

1. Political Instability (Russia, Honduras, Venezuela, etc.)
2. Small Markets (less liquid)
3. Poorly Regulated
4. Unusual Accounting
5. Currency Risk

However, I'd like to make the case for investing to make money from emerging markets. Five years ago my family and I took a trip to the Bay Islands of Honduras. While there I noticed that one of the only companies selling products to these Honduran Islanders was the Coca-Cola Company by way of the Fanta soda line. It reminded me of 1988 and Warren Buffett stepping outside of his usual proclivity to buy into the stock of a great company when the share price falls into some significant distress. Coke had gone up about five-fold since the bottom in 1982 and sported a trailing 12-month P/E ratio of 18. Buffett bought a major stake in the company and dumbfounded his fondest admirers in the process. Buffett said at that time that he "could go away for ten years" and he'd know that Coke would be doing well.

One of the main reasons that Buffett could have that kind of confidence was that the Berlin Wall was preparing to fall. Countries in Eastern Europe and Latin America were getting political freedom and adopting free-market capitalism. Any improvement in a third-world country's circumstances was going to create a chance to sell something clean to drink. Nobody does that better than Coca Cola. With Coke he never had to take the risks listed above to make money from emerging markets. He only had to trust the brand, the balance sheet, the distribution system, the economies of scale and the management of the company.

A front page article in last week's Wall Street Journal that discusses the distribution of drugs in emerging market countries tells you everything you need to know to make money investing in emerging markets in the next ten years. IMS Health reports that in 2003 there was $67.2 billion of prescription pharmaceuticals purchased in emerging market nations. In 2008 it had grown to $152 billion and IMS predicts it will hit $265 billion in 2013. How many companies in the world have the brands, balance sheets, patents, distribution, economies of scale and management to do this? Exporting health to the world will be an incredibly rewarding business both financially and ethically. It will help other businesses succeed by improving the quality and length of life for people in countries ranging from China and India to the smallest countries in Latin America and Africa. The difference this time is the companies that we are interested in like Merck and Pfizer are trading at distressed P/E levels as compared to the last twenty five years. Buffett did well on his investment in Coke, but the drug stocks start this cycle trading at distressed prices the way Buffett usually likes to buy shares.

Best Wishes,

William Smead

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